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SUBJECT: SHANGHAI AIRLINES FACES TURBULENT TIMES

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¶1. (SBU) Summary: Shanghai Airlines (SAL), China's fifth largest and first independently-run local airline, struggled through a string of economic blows in 2008, and the global economic slump is promising to bring more hardship in 2009. Shanghai Airlines Senior Vice President Gu Jiadan said the airline is struggling against sagging demand as Chinese consumers tighten their belts on business and holiday travel. To ease financial difficulties, Shanghai Airlines has requested a capital injection from the Shanghai Municipal Government. Shanghai Airlines lost close to USD 25 million from fuel hedging contracts in 2008 and is expecting to double the overall losses it suffered in 2007. Gu welcomed the Government's reduction in the fuel surcharges and said that the company would likely use the opportunity to boost ticket prices. He also said the airline will not postpone or cancel orders for Boeings in 2009, despite Government calls to delay aircraft orders from foreign manufactures. Gu was tight-lipped about rumors of a possible merger with China Eastern, but hinted something was possibly in the works. End summary.

2008 Tough Year for Shanghai Airlines

¶2. (SBU) Gu said 2008 was a very difficult year for Shanghai Airlines. Although the company made a profit during the first four months, a number of factors contributed to record losses for the year. During the first half of 2008, skyrocketing oil prices drove up costs substantially. The unusual snow storms in early 2008, which blanketed the south-eastern part of China, hit during the peak travel season of Lunar New Year, causing demand to sag as passengers decided not to travel. Shanghai Airlines was also forced to cancel flights because of the inclement weather. The May 2008 Beichuan Earthquake was particularly hard on Shanghai Airlines because it occurred just at the beginning of the summer tourist season and negatively impacted the flow of tourists to China's western provinces, one of Shanghai Airlines leading destinations. Gu added that many government officials

were also banned from traveling in general to show respect for the victims, which added to the slump.

¶3. (SBU) Chinese travelers have become more frugal on business trips and holidays as a result of the economic crisis, further dampening demand, Gu said. He added that, although there has already been a marked decrease in passenger loads from the economic crises, the impact has not yet been fully felt. Of all the factors, Gu said the Olympics hurt the airlines more than anything else. As the Government tightened air travel security for an extended period - before, during and after the Olympics - domestic passenger loads plummeted. Passenger flow to Beijing, however, picked up rapidly after restrictions were loosened, and the Shanghai - Beijing route has returned to being one of the most profitable routes for Shanghai Airlines.

Hedging Roulette - This Time on the Losing Side
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¶4. (SBU) When asked if Shanghai Airlines had suffered losses from oil hedging, Gu said the company only hedged a small amount, much less than other airlines, such as Air China. During the first half of the year when Shanghai Airlines' peers had all hedged heavily on fuel prices, he felt the company was too conservative. Now, he said he felt the company was very lucky compared with Air China, which lost several billion of RMB on hedging. In total, Shanghai Airlines lost RMB 170 million (USD 25 million) from fuel hedging contracts in 2008. (Note: A subsequent Shanghai Airlines statement released on January 21 said that the airlines losses in 2008 might be double those of 2009 due to "high oil prices, weak travel demand, and heavy hedging losses." The company lost RMB 435 million (USD 64

million) in 2007.)

Fuel Surcharge Reduction - A Welcome Break

¶5. (SBU) Gu also noted that as domestic jet fuel prices have fallen so have fuel surcharges. (Note: The National Development and Reform Commission (NDRC) and the Civil Aviation Administration of China (CAAC) on December 25 lowered fuel surcharges from RMB 150 to RMB 40 for flights beyond 800 km, and from RMB 80 to RMB 20 for those under 800 km. On, January 15 the fuel surcharge was completely eliminated.) Gu explained these surcharges are factored into the price of the ticket, and Shanghai Airlines is considering raising fares - although the overall ticket price would likely be cheaper. According to Gu, lower global crude oil prices should translate into cheaper airline fares and increase the number of passengers in the long run.

High-Speed Rail May Cut into Regional Business
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¶6. (SBU) Gu also noted that a large part of China's stimulus package was tied up with railway development. Some of the new lines may eventually cut into the airlines' business. Gu cited the Shanghai - Beijing high speed railway as an example, which is nearing completion. The travel time between Shanghai and Beijing will be cut to five hours, which is close to the current flight option if ground transportation and check-in time is factored in. However, in the larger picture, Gu said that high speed rail would give consumers more choice, but it was impossible to fully replace airlines, even on the Shanghai-Beijing route. Gu believed that as economic ties increase between the cities, there will be increased demand for both air and train transportation.

Capital Injection Hopefully on the Way

¶7. (SBU) Gu noted that both China Eastern and China Southern had each received RMB 3 billion (USD 440 million) from the Central Government to reduce debt burdens. As a result of their

injections, Shanghai Airlines decided to also seek assistance to help reduce its debt; however, the company is seeking assistance from its main share holder - the Shanghai Municipal Government. Gu said Shanghai Airlines is seeking far less than the RMB 3 billion provided to the other two airlines but would not disclose the amount. Although the Shanghai Government has not yet provided any capital to the airlines, the city has agreed in principle to support the company. When asked whether the Central Government's stimulus package would help the airline industry, Gu replied that the additional funding would likely help in the long run. Some of the stimulus package will be used for building and improving regional airports, which will support some of Shanghai Airlines' domestic routes. There is a current government study underway looking into a tax reduction for the airline companies in China, which, he added, would be a real boon for the industry.

Despite Beijing "Guidance", SAL Still Ordering Boeings
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¶8. (SBU) Despite CAAC's recent promptings for domestic airlines to suspend or cancel purchases of new planes from foreign manufacturers, Gu assured that Shanghai Airlines would not change their purchase orders for Boeing planes in 2009. (Note: On December 9, CAAC asked domestic airlines to suspend purchases of foreign planes to cut operation costs and maintain a balance between demand and supply.) However, he quickly added that Shanghai Airlines will consider reducing its 2010 order if things get worse. According to Gu, Shanghai Airlines has close ties with Boeing, and the majority of its aircraft are purchased from Boeing. However, Gu did complain that Boeing's delayed

delivery to Shanghai Airlines of the 787 Dreamliner (currently nine on order) caused Shanghai to postpone plans for a direct flight between Shanghai and Hawaii. (Note: Shanghai Airlines was one of the first airlines to order the Boeing 787.) When asked about Shanghai Airline's plan to purchase China's newly-developed regional jet, Gu said the ARJ21 would only replace its current Bombardier CRJ-200 jets, given the ARJ21 has more seats and lower maintenance costs. Shanghai Airlines has ordered five of the new planes. The ARJ21 will not replace the company's Boeing jets because they have different functions. Shanghai Airlines currently has 55 Boeings in its fleet. In total, the company hopes to have a fleet of 100 aircraft by 2010 capable of handling almost 18 million passengers a year.

Merger with China Eastern in the Works?

¶9. (SBU) Regarding the widespread rumor on a possible merger with China Eastern Airlines, Gu said he was unable to comment, but hinted something is possibly in the works. However, he said his personal point of view was that it was not beneficial to create such a giant airline company that would dominate the market. It will reduce consumer choice and stifle competition. The current economic slowdown should not be used as a reason for industry consolidation, said Gu. He added such a tie-up would also be very complicated since China Eastern Airlines and Shanghai Airlines are owned by two different levels of government - central and municipal. (Comment: Gu's views on airline consolidation are largely out of step with those of the Central Government and the Shanghai Government. The Central Government has been urging industry consolidation for years. For example, a December 9 statement released by the CAAC said the agency will support further alliance and consolidation of the country's airlines to help increase their overall competitiveness. Many rumors also abound that the Shanghai Government also supports such a tie-up.)
CAMP